APPENDIX

FOMC BRIEFING - P.R. FISHER

JANUARY 31 - FEBRUARY 1, 1995

Mr. Chairman:

I will be referring to the three color charts on the single page distributed this morning.

In describing domestic interest rate and foreign exchange markets over the period, I will try to answer two questions:

First: Why have expectations for interest rate increases come down so much over the period, and

Second: Why has the dollar weakened so much against the German mark?

In response to the first question, I think that expectations for interest rate increases have unwound so much because they were exaggerated -- at least, in part, because commonly-accepted measures of those expectations were distorted by a number of factors at the end of last year.

At the end of November and into early December, the short-end of the yield curve backed-up sharply as a number of bank portfolios closed out positions in two- and three-year paper and as Orange County's financing positions and portfolio were liquidated. At the same time, market expectations for the Committee's actions implied something of an extrapolation of what was seen as the Committee's more aggressive approach in November. Moreover, these two phenomena were mutually reinforcing. Even as market participants began to think that concerns about the implications of Orange County might prevent an increase in rates in December, market expectations for 150 basis points of tightening by May appeared to justify 2-and 3-year yields over seven and one half percent and, at the same time, short-end yields at these levels were seen as confirming expectations for a rapid increase in the Fed funds rate.

Over the course of January, there has been a gradual unwinding both of expectations for Committee action and of the "hump" in the yield curve.

For example, a major step in this process occurred following the release on January 13th of the weaker-than-expected retail sales. In the first two panels of charts -- depicting the rates implied by the monthly Fed Funds Futures contracts and the yield curve -- the impact of this process can particularly be seen in the shift from the green to the orange lines: shaving expectations for this meeting to a 50 basis point increase and, more significantly, lowering the pace of expected increases in the future.

While most people in the market remained skeptical about either the accuracy or enduring significance of the retail sales data, it did serve to remind market participants that they were increasingly likely to face two-way risk in upcoming data releases. This, in turn, gave confidence to those wanting to lock in the relatively high 2-to 5-year yields. Thus, despite much talk of "heavy supply," the market finally began to work down the hump in the yield curve.

The release of fourth-quarter GDP last Friday, particularly the inventory investment component, provided a similar occasion: while the inventory estimate may be subject to revision, it provided both a hint of a softening of demand and a reminder of two-way risk in upcoming releases.

Turning to the dollar, in my opinion, it was precisely the progressive unwinding of expectations for the Committee's actions, and of short-end yields, that began to weigh on the accumulated long-dollar positions in late December and triggered the dollar's initial decline. While the Mexican financial crisis has recently begun to weigh on the dollar, this only became a significant factor in mid-January, after the dollar's decline was already well underway.

In December, I mentioned the surprising resilience of the dollar in the face of events which, earlier in the year, would have been expected to cause dollar weakness. (These included the resignation of Secretary Bentsen, the oscillations of the yield curve surrounding Orange County and the Bankers Trust supervisory announcement.) The strong demand for dollars -- both corporate and speculative -- was predicated on the numerous forecasts that the dollar would rise in 1995. To a great extent, these forecasts themselves were based on: the implications of the rapidly flattening yield curve; the extrapolative projections of the Committee's likely actions; and the absence of any data yet indicating a slowing of the economy.

Having brought forward much of the demand for dollars into early December, there were few firms seeking to buy dollars after the Committee's December meeting. In thin, holiday markets on December 28th, after the European close, the dollar was subject to an energetic effort to push it lower by triggering stop-loss orders. Given the lack of interested buyers, the dollar dropped almost 3 pfennings in less than half an hour. However, it <u>was</u> noted, and <u>should be</u> noted, that this initial drop merely returned the dollar to the levels, around 1.55 marks, where it had traded for several days <u>after</u> the Committee's November 75-basis point increase.

The dollar's second step lower occurred as a result of a rush of demand for marks coming out of the politically- and fiscally-weak European currencies. It appears that several major intermediaries, having taken long-dollar, short-mark positions over the year-end, were caught wrong-footed by their customers' demand for marks. The quickest way to adjust their positions was to sell dollar-mark and, on January 9th, again in New York trading, the dollar fell nearly two pfennings in under 45 minutes.

With the dollar having demonstrated a surprising downward momentum, and the yen eventually becoming subject to the uncertainties of the Kobe earthquake, the mark quickly came to be seen as the reserve currency of choice, rising to within a hair of its all-time high on a trade-weighted basis on January 25th. [199.40 vs. 200.40 on 10/5/92]

Thus, the dollar's first two steps lower were caused by the unsustainability of the long-dollar positions, built-up in December, in the face of the decreasing extent of expectations for rate increases. But by mid-January, as the expected duration of the Mexican crisis shifted from temporary to indefinite, the Mexican situation did begin to weigh on the dollar. But there is nothing especially "Mexican" about the specific mechanisms through which the crisis has affected the dollar.

First, the Mexican crisis provided a further reason for the unwinding of expectations for Committee actions -- on the assumption that the Federal Reserve would not want to make matters worse. Indeed, because of the peso's weakness, and the weakness of the Mexican financial system, foreign exchange market participants became increasingly skeptical about the prospects for the Committee to raise rates and about the prospects for the dollar to rise even in the event of a Committee action.

Second, the Mexican crisis served as a catalyst for the development of an alternative, negative forecast for the dollar in 1995, which goes something like this: If emerging market economies, and Mexico in particular, are going to be a decreasing source of demand for U.S. goods and services, while the U.S. economy continues to grow strongly, then the U.S. current account deficit is likely to increase. If one combines a forecast for an increasing current account deficit with a forecast for U.S. interest rates to rise less, and less quickly, than previously assumed, it is hard to see why one would expect the dollar to move higher.

Finally, last week and on Monday, the foreign exchange market has had something of a knee-jerk, negative reaction to the political back-and-forth over the Mexican aid package. Yesterday, the dollar got an initial bounce-back in early European trading on rumors of concerted central bank dollar support, indicating the nervousness of those who had taken short-dollar positions. Apparently, just as the market was getting comfortable with the idea that we were unlikely to be intervening, and short-positions were being reestablished, President Clinton's announcement hit the wires that "executive authority" would be used for the Mexican package. The scramble to cover short positions again was made more urgent by the rumors that the ESF would be selling its marks and yen to fund the package.

Looking back over the month, it seems to me that by dint of repetition, Mexico has become a bigger part of the accepted explanation of why the dollar moved lower than is deserved. But now that the dollar is lower, and the perception of Mexico as a contributing cause is widespread, the unresolved nature of the peso crisis is one of the factors holding the dollar down.

In addition to the peso's weakness, the Canadian dollar has been under pressure during the past month. The markets exacted a high price from the Bank of Canada for its failure to raise rates in November in step with the Committee's 75 basis points. Their lagging rate increases, combined with market anxieties about the Canadian government's fiscal policy and the Quebec separatist referendum, brought the Canadian dollar to a 9-year low against the U.S. dollar [1.4269 1/20] and pushed 30-year Canadian interest rates up by over 50 basis points from early December. By last week, however,through repeated rate increases, the Bank of Canada seems to have persuaded the market that it will maintain the higher, short-term rates to defend the currency, stabilizing their dollar and bringing long-term rates back down. If the Committee were to raise rates, I would expect the Bank of Canada to match it with a 50 basis point increase of their own.

Turning to the Desks' operations, throughout the period, domestic operations were aimed at maintaining the existing degree of reserve pressure, with Fed funds expected to trade around 5 and one half percent, as directed by the Committee. Year-end pressures in the funds market only reached 7 percent, and by the time traders left their desks for the New Year weekend, the funds rate had touched a low of one-quarter percent.

The first part of the current maintenance period required a draining of reserves as the seasonal increase in required reserves and in currency rapidly reversed themselves. Because of the expected need to return to adding reserves in upcoming maintenance periods, we met our draining needs with temporary transactions and by the redemption of 600 million dollars in 7-year Treasury notes which matured without replacement. Over the past few days, we have returned to adding reserves as a rise in the Treasury balance has introduced a temporary need, while security market settlement pressures and expectations for a policy move at the conclusion of this meeting have worked to elevate rates in the money market.

Over the three maintenance periods since your last meeting, the effective Fed funds rate has averaged 5.42, 5.49, and, as of last night, 5.55 percent.

Mr. Chairman, other than the 1.5 billion dollars in swap drawings by the Bank of Mexico, during the period we had no foreign exchange operations on behalf of the System's account.

I would be happy to answer any questions.